T H E R E T I R E M E N T P R O J E C T

URBAN INSTITUTE

Brief Series • **No. 10** • June 2000

Employee Stock Ownership Plans: A Status Report

Pamela Perun

FOR THE PAST 25 YEARS, EMPLOYEE STOCK ownership plans (ESOPs) have provided employers with a means to transfer substantial ownership interests to their employees. But as the popularity of company stock as an investment for employees increases, employers have some new alternatives to consider. This report reviews the current status of ESOPs and describes the competition. In addition, it speculates about the future role of ESOPs.

ESOPs are unique within the U.S. retirement system. Retirement plans are generally designed to provide participants with income in retirement or at termination of employment. ESOPs share that goal but, unlike other types of plans, have a dual purpose. They are also designed to promote employee ownership of capital assets. ESOPs were originally developed in the 1950s by banker Louis Kelso, who argued that the long-term interest of capitalism is best served by providing employees with ownership of corporate securities and additional income beyond salaries and wages. With the passage of the Employee Retirement Income Security Act of 1974 (ERISA), ESOPs were formally recognized as a means for providing employees with an opportunity to earn an equity interest in the corporation that employs them on a tax-advantaged basis.

Today, ESOPs serve a variety of tax and nontax functions. Many advocates argue that providing employees with ownership interests increases motivation and productivity. This in turn leads to better corporate performance, which benefits all shareholders. As explained below, ESOPs are also frequently used as a corporate finance technique. In addition, they can be an important instrument of corporate control, whether used as an antitakeover device by a public company or, conversely, as a method of business succession planning by a private company.

HOW ESOPS WORK

For many years, the tax code has authorized employers to establish stock bonus plans, which provide an opportunity for employees to acquire company stock. A stock bonus plan is a qualified, defined contribution plan. Employers have the discretion to make yearly contributions on behalf of their employees. Contributions need not be made or invested in company stock but usually are, and employees have the right to take plan distributions in the form of company stock.

An ESOP is essentially a stock bonus plan but with two important distinctions.[1] First, an ESOP is required to be invested primarily in the securities of the employer sponsoring the plan or one of its affiliates.[2] This means that, unlike most other qualified plans, the assets of an ESOP are not diversified among a variety of investments. Second, an ESOP, unlike any other qualified plan, may be leveraged. This means that the plan is permitted to borrow money, typically from a commercial lender but sometimes from the employer itself, to purchase the securities. The loan is secured by the stock and usually guaranteed by the employer as well. The stock is held in an unallocated suspense account in the plan's trust. Over time, tax-deductible employer contributions to the plan and often dividends paid on the stock are used to repay the loan. As the loan is repaid, an equivalent amount of stock is released from the suspense account and allocated to the participants' individual accounts.

ESOP participants generally have the same rights, such as the right to receive dividends, as other shareholders with respect to the stock in their accounts. Participants have full voting rights for shares allocated to their accounts in ESOPs of public companies. But ESOPs in privately held companies are only required to permit participants to vote on such major corporate events as a merger, acquisition, recapitalization, or sale.[3] On other corporate matters, the ESOP trustee, who is often a corporate officer, votes the shares on behalf of participants. Participants are not free to sell their shares or diversify their holdings while employed until reaching age 55 and completing 10 years of participation. At that point, the ESOP is required to begin providing them with either an opportunity to receive a distribution or a choice of other investment options—through the ESOP or another plan sponsored by their employer—for a portion of their accounts. Only upon termination of employment are participants free to receive the vested portion of their accounts in stock or cash. They can hold or sell their shares directly or transfer them to an IRA, where they can be sold at will.

Because an ESOP is a qualified plan, it offers a number of tax advantages to employers. Congress has added additional tax incentives to make ESOPs especially attractive, although many of the more generous incentives have since been repealed.[4] Those that remain largely benefit leveraged ESOPs. For example, employer contributions to all qualified plans are made on a tax-deductible basis, subject to tax code limits. But while employer contributions to nonleveraged ESOPs are usually deductible only up to 15 percent of covered compensation, contributions to repay principal on an ESOP loan are deductible up to 25 percent of covered compensation.[5] Contributions to repay interest on the loan are deductible in an unlimited amount. Employers can also generally deduct dividends paid on ESOP-held stock without limit, provided that the dividends are "reasonable" and are either paid directly to participants or through the ESOP within a prescribed time period. Dividends used to repay a loan are also generally deductible without limit.[6]

The tax benefits described above distinguish ESOPs from other types of qualified plans. But leveraged ESOPs are frequently promoted as attractive devices for raising new equity capital or refinancing existing corporate debt. However, as Congress has narrowed the available tax benefits, they have become less attractive. For example, until recently, qualified lenders could exclude 50 percent of the interest received on loans made to ESOPs. When this provision was in effect, it enabled ESOPs to borrow at a lower interest rate than that available for general corporate purposes. The primary remaining advantage of a leveraged ESOP is the deduction for principal repayments, which is not generally available through other corporate finance techniques.

ESOP participants also receive some special tax advantages. For example, participants in defined contribution plans are limited to annual account allocations of $30,000 or 25 percent of compensation, whichever is less. But if at least two-thirds of those contributions attributable to interest repayments to a leveraged ESOP benefit non–highly compensated participants, these contributions and forfeitures do not count against this annual limit.[7] In addition, participants in ESOPs may take advantage of a special tax rule only for employer stock distributions. This rule provides one of the few remaining opportunities for capital gains tax treatment available through qualified plans. Under this rule, participants who receive a qualifying distribution and do not roll their shares over to an IRA are not automatically taxed on any appreciation in the shares while held in the ESOP. Instead, they can elect to postpone taxation until the shares are actually sold, at which point any gain is taxed at capital gains rates.[8]

Finally, ESOPs provide family companies with an attractive means to transfer ownership to employees when no second generation is interested in carrying on the business. ESOPs also provide substantial owners with an estate-planning strategy for an asset that is illiquid but often constitutes the major asset in the estate. Congress encourages owners of private companies to form ESOPs by providing special capital gains tax treatment under Internal Revenue Code § 1042. Through this provision, for example, owners of a privately held "C" corporation can defer or even avoid tax entirely by selling their company, through an ESOP, to their employees rather than to outside parties. Provided certain requirements are met, a shareholder can sell shares to an ESOP, reinvest the proceeds in other securities, and postpone paying long-term capital gains taxes on the sale.[9] If the replacement securities are held until death, when they receive a step-up in basis, the owner never pays income tax on the sale proceeds, although estate tax still may be due.[10]

SOME CURRENT STATISTICS

According to the most recent available data, there were about 800,000 retirement plans at the end of the 1997 plan year.[11] Only about 1 percent, or 8,095, of those plans were ESOPs, although another 1,995 plans indicated that they were stock bonus plans not designated as ESOPs. The most recent official U.S. Department of Labor statistics on ESOPs, based upon comparable data, are for 1995. At that time, there were a reported 9,232 ESOPs, excluding one-participant ESOPs, covering 7 million active participants and including $262 billion in assets.[12]

A comparison of 1995 and 1997 figures suggests that the number of ESOPs has been declining in recent years—but one private estimate of ESOP prevalence reports substantially higher numbers. The National Center for Employee Ownership projects that there were 11,100 ESOP-like plans in 1997 covering 8.7 million people. However, its figures include plans not legally designated as ESOPs, although they may have similar features.[13]

A closer look at 1997's 8,095 plans reveals some surprising findings. About one-third, or 2,636, of them were terminated during the year, with the restructuring of a specialty retailing group of entities accounting for over 80 percent of those terminations.[14] Another 5 percent, or 407 plans, were in the process of terminating.[15] About 2 percent, or 149 plans, were new plans. The remaining 61 percent, or 4,903 plans, were continuing ESOPs. Simple addition indicates that by the end of the 1997 plan year only 5,052 new and continuing ESOPs could be counted as active ESOPs.

Active ESOPs

Based upon the 1997 data, these ESOPs present a diverse picture.[16] They cover more than 4.3 million active participants and include over $164 billion in assets. The continuing ESOPs, on average, are 13 years old, although there are many that predate ERISA (including one claiming to be 98 years old). Only a minority of the ESOPs, 16 percent continuing and 23 percent new, are leveraged, although no particular pattern of leveraging is evident in the data. Plan asset size also varies widely. The median size among continuing ESOPs is about $1.1 million; the mean is $33.5 million. The largest ESOP by this criterion is sponsored by General Electric Company and has over $19 billion in assets and about 140,000 active participants. On the other hand, many small plans also have substantial assets, including a one-participant ESOP with assets of over $66 million that covers a reportedly non–highly compensated individual.

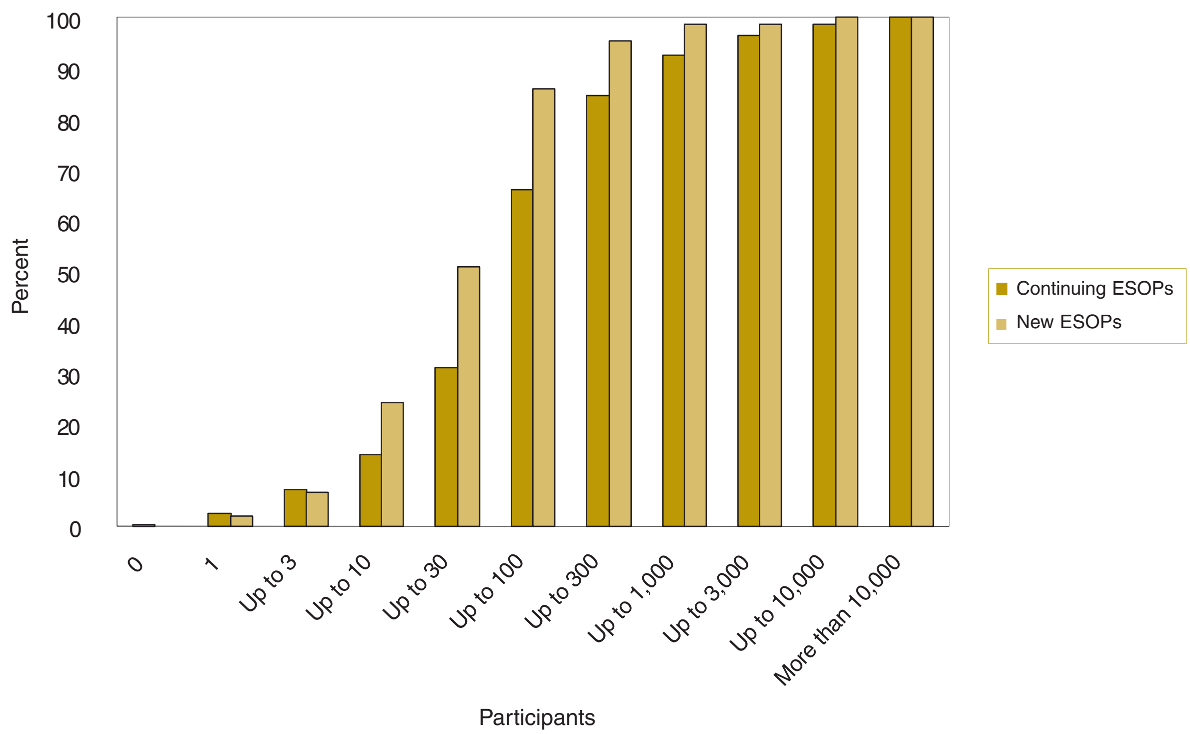
Some ESOPs cover many employees. For example, the Wal-Mart Stores Inc. ESOP has the largest number of active participants, 464,725, representing 54 percent of the company's almost 900,000 employees. But many ESOPs are much smaller and cover only a few participants. The total range of plan sizes is illustrated in figure 1.

Continuing ESOPs are, in general, larger than newly created ESOPs. The median number of active participants in a continuing ESOP is 61 employees; in a new ESOP, the median is 28 employees. The means (and standard deviations) are 877 (8,770) participants and 108 (456) participants, respectively. These figures indicate that about 30 percent of continuing ESOPs and 50 percent of new ESOPs have 30 or fewer participants. About 85 percent of continuing ESOPs and 95 percent of new ESOPs have 300 or fewer participants.

From a participant perspective, a different picture emerges. The majority of participants are found in the larger plans, as shown in figure 2. This figure indicates that about 97 percent of all participants are in plans with more than 100 participants and about 80 percent are in plans with 3,000 or more participants.

Although plans with many participants are generally associated with larger, presumably more profitable, corporations,

FIGURE 1.
Cumulative Frequency of Plan Size, by Number of Active Participants



they do not necessarily receive higher employer contributions. In many cases, as shown in figure 3, smaller plans provide more generous contributions as measured by average contributions made in 1997. Participants in plans with between 100 and 300 participants receive the most generous average contribution, about $2,000. But participants in one-participant plans receive the second most generous average contribution of about $1,700. Participants in the largest plans, those with more than 300,000 participants, receive the least generous contribution of about $300.

Terminating ESOPs

It is difficult to generalize about terminating ESOPs from the data. Plan termination can be a lengthy process, and measures such as plan asset size and number of participants continually change as the trust winds down. To understand which plans terminate and why they terminate would require, at a minimum, additional longitudinal data.

On a descriptive level, the data indicate that these ESOPs have an average age of 13 years and that 16 percent of them are leveraged, characteristics identical to continuing ESOPs. But the data do seem to suggest that the size of the corporation distinguishes the two groups. More smaller corporations appear to be terminating their plans. For example, the median number of employees in terminating ESOPs is 54, with an average of about 1,000 and a standard deviation of about 6,000. The median number of employees in continuing ESOPs is 77, with an average of about 2,000 and a standard deviation of about 19,000. This same pattern can be seen in the asset size of sponsoring corporations. The median asset size of corporations terminating their ESOPs is $500,000, with an average of $40 million. The comparable figure for corporations continuing their ESOPs is $2 million, with an average size of $170 million. Although these differences are statistically significant, it is important not to overemphasize the relationship. Many of these corporations may be experiencing a corporate dissolution or sale that requires an ESOP termination. These ESOPs and their sponsors may have had very different characteristics while the ESOPs were in active status.

Terminated ESOPs

Although all plans in this group have filed a final Form 5500, the data do not distinguish between those terminated by distribution of assets to participants and those terminated by merger or consolidation with another ongoing plan.[17] About 90 plans appear to fall into this latter category. From the remaining ESOPs, a picture similar to that presented by terminating ESOPs emerges. These ESOPs were, on average,

FIGURE 2.
Cumulative Frequency of Number of Active Participants, by Plan Size

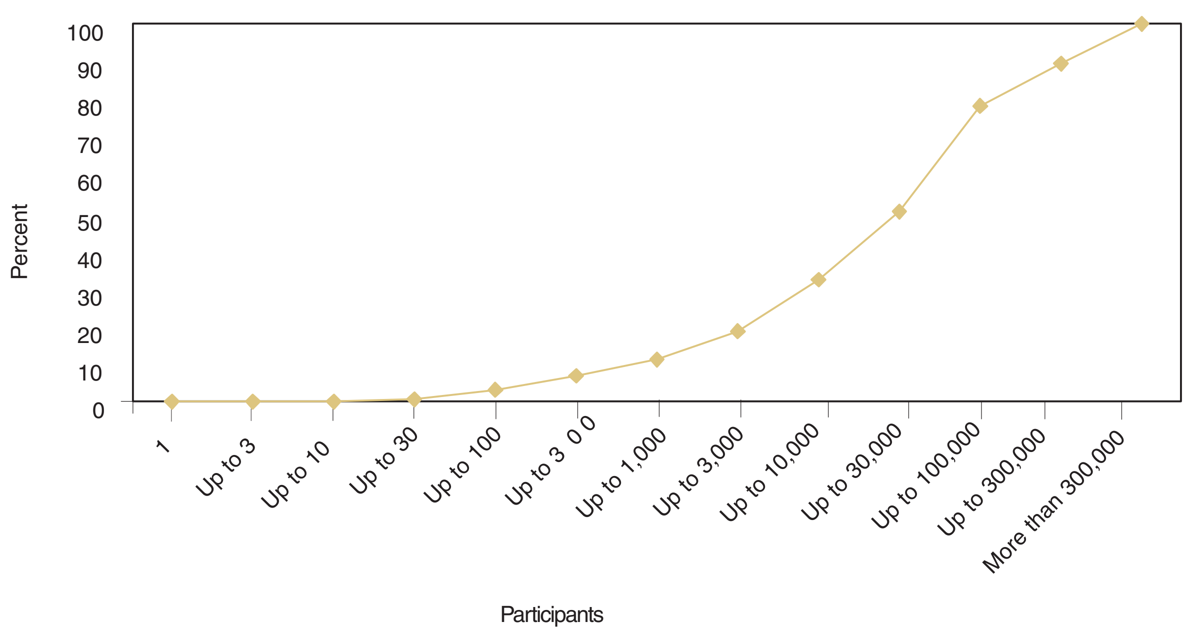
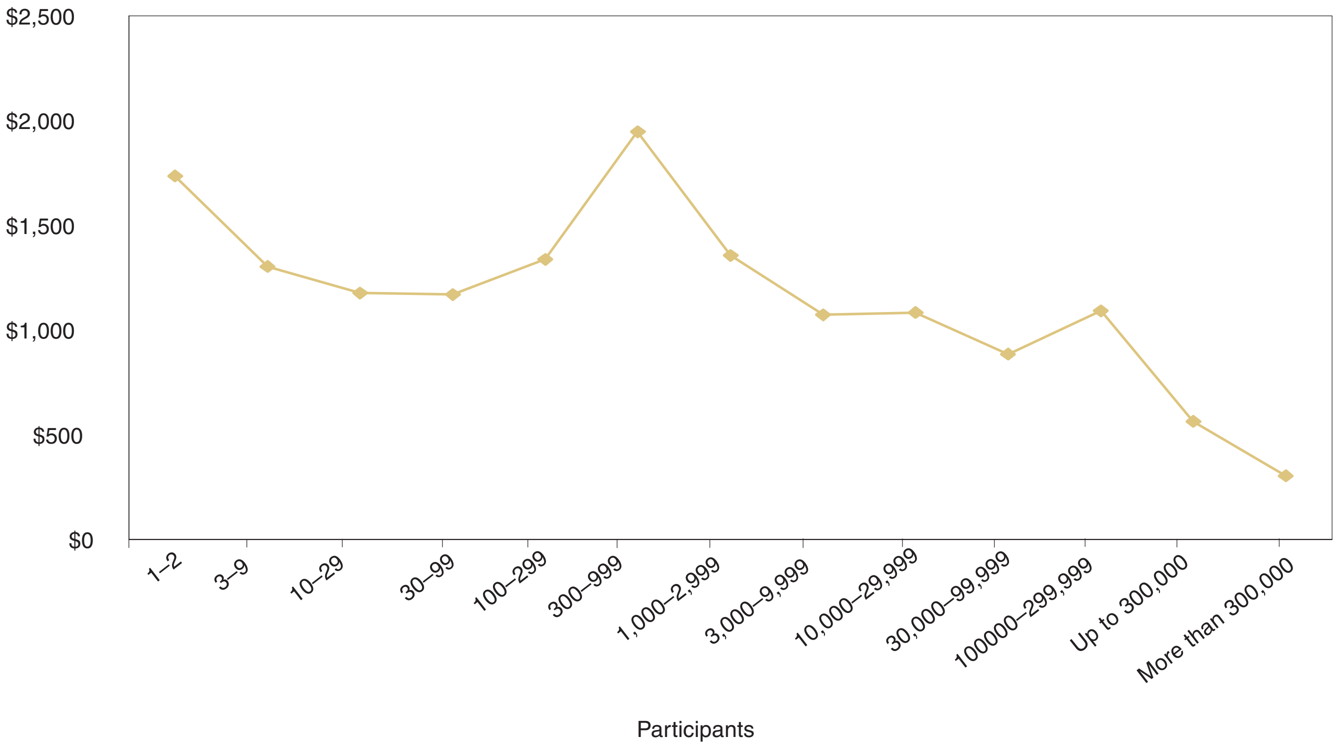


FIGURE 3.
Average Contribution to Plans, per Active Participant in 1997



12 years old and about 18 percent of them were leveraged, characteristics similar to terminating ESOPs. Again, it is predominantly the ESOPs of smaller employers that have terminated. For example, the median number of employees in this group is 37, with a mean of about 800 and a standard deviation of about 2,900. The median corporate asset size is $500,000, with a mean of about $47 million. When compared to continuing ESOPs these differences are statistically significant, but, as is the case with terminating ESOPs, other factors may be influencing the data.

The implication in these data that smaller companies are more likely to terminate their ESOPs is highly plausible. ESOPs are expensive and complicated plans, and many smaller companies find them too difficult to maintain. In addition, ESOPs have been oversold in the small-employer market and are often promoted to companies for whom they are not appropriate. Finally, smaller companies tend to fail in greater numbers than larger companies.

ALTERNATIVES TO ESOPS

When ESOPs were invented, few employees participated in the equity markets on their own or owned employer stock unless their employer sponsored a stock bonus plan. An important justification for creating ESOPs was that they would enable employees to acquire a substantial ownership interest in their employer. But other mechanisms are available today to accomplish this same purpose. In the past 10 years, plan participants have increasingly assumed responsibility for investing their own accounts in defined contribution plans. In many plans, mutual funds are the sole investment options. But growing numbers of participants now have the opportunity to purchase individual stocks, including the stock of their employer, through self-directed brokerage accounts.

At the same time, companies are now making employer stock available to employees through a number of alternatives. Many defined contribution plans now routinely offer a company stock account as an investment option. Many companies also match employee contributions to a 401(k) plan in employer stock. Companies often offer a broad-based stock purchase plan that enables employees to purchase company stock at a 15 percent discount.[18] A growing number of companies are even expanding their stock option plans, formerly reserved for executives, to a wider range of employees. The National Center for Employee Ownership estimates that in 1998 4,000 stock purchase plans covered 15.7 million participants, but the Center was unable to estimate the value of the assets held in those plans. It also estimates that 3,000 broad-based stock plans covered 7 million participants, with perhaps $250 billion in assets.[19] If these figures are correct, stock purchase and option plans may soon, if they have not already, eclipse ESOPs as the customary means to expand employee ownership.

Table 1 compares ESOPs with new alternatives for employee ownership. In most respects, these new alternatives are equivalent to ESOPs. They all provide some form of tax benefit, employer contribution or subsidy, and shareholder rights. In many respects, the new alternatives are superior. They provide more choice to employees regarding level of participation and investment, a greater ability to diversify stock holdings into other types of investments, and more opportunity to respond to changing market or company conditions. These can be important considerations. Not all companies with ESOPs prosper, and employees can reach retirement age only to find that their ESOP shares, perhaps their primary retirement benefit, have little value.

Employee stock purchase and stock option plans can be particularly attractive alternatives because they are *not* qualified plans. They are probably less expensive to establish and operate and are certainly subject to far less government regulation. An ESOP, for example, can cost even a small employer over $100,000 to establish and many thousands of dollars a year to maintain. ESOPs are also subject to the complex nondiscrimination rules, coverage standards, and contribution limits applied to qualified plans as well as their reporting and disclosure requirements. ESOPs are relieved of some of the standard fiduciary obligations to which other qualified plans are subject. But they can also create troublesome fiduciary dilemmas when, for example, the voting of company stock held in an ESOP becomes a corporate control issue.

Only with respect to participation in management may ESOPs have an edge over other alternatives. Participation in management appears to be a key component of any success attributable to employee ownership in enhancing corporate performance. The few studies of ESOP performance vary widely in terms of method and scope. After a recent survey of studies, the National Center for Employee Ownership concluded that enhanced corporate performance could be quantitatively demonstrated in such areas as productivity and increased levels of sales and employment.[20] In addition, the Center found some evidence that companies with ESOPs exhibited higher levels of employee wages and benefits. But these results were qualified in several respects. First, the effect, if any, was apparent only in small companies. ESOPs in large companies, where most ESOP partic-

TABLE 1.

Comparison of Employee Stock Ownership Alternatives

Impact	ESOPs	Company Stock Accounts in Qualified Plans	Employee Stock Purchase Plans	Broad-Based Stock Option Plans
Employees can choose to participate in the plan	No	Usually	Yes	Yes
Employees can determine how much to invest	No	Usually	Yes	Yes
Employees can receive employer contribution/subsidy	Yes	Yes, employer option	Yes, through discount	Yes, through option price
Employees can buy or sell in response to market or company conditions	No	Usually	Yes	Yes, if vested
Employees can diversify stock holdings	Only after age 55 and 10 years of participation	Usually	Yes, by selling	Yes, by selling after vesting
Employees can exercise shareholder rights	Yes in public companies, sometimes in private companies	Yes	Yes	Yes
Employees can participate in/influence management decisions	Maybe in small companies, maybe in large companies if ESOP has board seats	Usually not	Usually not	Usually not
Employees can obtain some form of favorable tax treatment	Yes	Yes	Yes	Yes

ipants are found, seem to be just another employee benefit. Second, and most important, both employee ownership and participation in management must be present for these effects to appear.[21] Neither is sufficient in and of itself. But participative management styles are becoming increasingly popular even in large corporations, and a wide variety of corporations are now offering some means for employee ownership other than an ESOP. So, without additional research on these new trends, it is premature to conclude that ESOPs are peculiarly effective in enhancing corporate performance.

Some 50 years later, Louis Kelso's vision for employee ownership has begun to be fulfilled, but perhaps in ways he would never have anticipated. Millions of employees now hold an ownership interest in the corporations that employ them and possess a second income from their equity investments. But the mechanism he created for this purpose is in danger of becoming obsolete. Companies now have access to less complicated and more versatile means for aligning employee and corporate interests. Employees also have greater choice about how much company stock they will hold and when they will buy and sell it. The future of employee ownership does not appear to belong to ESOPs. But ESOPs still retain special financing and tax benefits particularly attractive to the small, privately held company. As long as Congress believes providing tax subsidies for ownership transfers to employees in such companies is important, ESOPs will most likely survive for this special purpose rather than as a primary employee benefit.

ENDNOTES

[1]An ESOP can also be part of a stock bonus/money purchase pension plan combination or added to a 401(k) plan, which is then known as a KSOP.

[2]ERISA § 407(d)(6).

[3]Internal Revenue Code §§ 401(a)(22) and 409(e).

[4]In the late 1970s, qualified contributions to certain ESOPs known as "TRASOPs" received an extended investment tax credit. Beginning in 1983, the credit was shifted from an investment to a payroll tax credit and qualifying ESOPs then became known as "PAYSOPs." By 1987, the tax credit was repealed and replaced with the deduction described above.

[5]Special rules, which will not be discussed here, apply to ESOPs established by small corporations known as "S" corporations.

[6]Internal Revenue Code § 404(k).

[7]Under Internal Revenue Code § 414(q), the threshold for determining who is "highly compensated" in 2000 is an income of at least $85,000.

[8]Internal Revenue Code § 402(e)(4)(b).

[9]The most important requirements are that (1) the owner must have owned the stock at least three years, (2) the ESOP must own at least 30 percent of the company after the sale, and (3) the owner must reinvest the proceeds in qualified replacement property (generally, stocks or bonds of domestic corporations) within 12 months after the sale.

[10]Until 1989, Congress even permitted generous estate tax exemptions for sales of employer stock to ESOPs. Under a now-repealed provision, estates could deduct the proceeds received from such a sale, up to 50 percent of the value of the estate or $750,000 in estate taxes.

[11]The data cited are from Judy Diamond Associates in Washington, D.C., and are derived from the annual reports (Form 5500s) that most retirement plans are required to file with the federal government. These reports are filed on the basis of the plan year, which is usually, but not always, the calendar year. For the sake of simplicity, these data will be described as 1997 data although they actually are 1997 plan year data, which, for some fiscal year ESOPs, extends into 1998. Not all plans file on a timely basis, so these data may not be complete. In addition, many plans are not subject to this filing requirement, so their data are not available. For example, most IRAs, 403(b) arrangements, and plans sponsored by state and local governments are exempt from the filing requirements. But, given that ESOPs are peculiar to corporate entities, it would be expected that all ESOPs would be required to file a Form 5500.

[12]Table D9 in Private Pension Plan Bulletin, *Abstract of 1995 Form 5500 Annual Reports,* 1999, number 8, Washington, D.C.: U.S. Department of Labor. Under the Form 5500 definition, an active participant includes current employees and nonvested former employees who will retain benefits previously earned if rehired within statutory periods.

[13]These data are reported at http://www.nceo.org and are based upon estimates using Internal Revenue Service determination letter, not Form 5500, filings.

[14]For purposes of this report, "terminated" means the plan indicated it was filing its final Form 5500, which requires a demonstration that the trust has distributed all assets, either in payments to participants or of plan expenses or by transfer to another plan.

[15]"Terminating" means that the plan indicated either it had no remaining participants due benefits under the plan or it had been formally terminated. None of these plans had filed a final Form 5500, and many had not yet distributed all assets from the trust.

[16]A caveat is warranted with respect to these statistics. Form 5500 data are not entirely reliable, due to the complexity of the form itself and the variety of plans on which information is collected. In addition, an ESOP can either be a stand-alone plan or a component of another plan. In the latter case, the statistics reported on assets and contributions as well as participation are based on the plan as a whole rather than on the ESOP component alone. So, many of the figures reported here may be exaggerated, except in the case of stand-alone plans.

[17]These statistics do not include the over 2,000 ESOPs terminated by one related group of companies in 1997. These plans were such a special case that their inclusion would have distorted the analysis of the other plans.

[18]Stock purchase plans are authorized by Internal Revenue Code § 423.

[19]See "A Statistical Profile of Employee Ownership, updated October 1999" at http://www.nceo.org.

[20]See "Employee Ownership and Corporate Performance," April 1998. The National Center for Employee Ownership.

[21]These reported interactions between participation in management, small company size, and employee ownership are puzzling. It would seem that one critical component of participation in management would be an opportunity to vote on corporate matters. But ESOP participants in closely held companies are not legally entitled to, and most do not have, these ordinary shareholder rights except in the most important corporate matters such as the sale, merger, or liquidation of the company.

URBAN INSTITUTE
2100 M Street, N.W.
Washington, D.C. 20037

Telephone: 202-833-7200
Fax: 202-429-0687

e-mail: paffairs@ui.urban.org
Urban Institute Web site:
http://www.urban.org

This brief is available on the Retirement Project's Web site:
http://www.urban.org/retirement

THE RETIREMENT PROJECT

Employee Stock Ownership Plans: A Status Report

Pamela Perun

ABOUT THE AUTHOR

Pamela Perun is a consultant to the Retirement Project at the Urban Institute. She holds a law degree from the University of California at Berkeley and a Ph.D. in developmental psychology (adult development and aging) from the University of Chicago. She has practiced as a benefits lawyer for 10 years in Boston and Washington, D.C., and also has held research appointments at Duke University, Wellesley College, and Harvard Medical School.

The Retirement Project

The Retirement Project is a multiyear research effort that addresses how current and proposed retirement policies, demographic trends, and private-sector practices affect the well-being of older individuals, the economy, and government budgets. The project is made possible by a generous grant from the Andrew W. Mellon Foundation.